

FOR RELEASE ON DELIVERY

Approximately 1:00 p.m., EDT,  
Thursday, May 20, 1965.

NATIONAL GOALS AND INTERNATIONAL RESPONSIBILITY:  
SOUNDING A CHANNEL BETWEEN THE SHOALS

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Bankers Luncheon  
Sponsored by the Federal Reserve Banks of New York and Philadelphia  
62nd ANNUAL CONVENTION OF THE NEW JERSEY BANKERS ASSOCIATION

12:45 p.m., Thursday, May 20, 1965  
Wedwood Room, Haddon Hall, Atlantic City, New Jersey

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In the two years since I spoke to you last, we have endured strains and stresses: the assassination of a President; international political crises, ranging from the Gulf of Tonkin incident to the policy of strategic bombing in Viet-Nam north of the 17th parallel and the threat of a communist take over in the Dominican Republic; the deposition of Premier Khrushchev, and the wrath of General De Gaulle.

On the economic front, the superstructure of economic finance created since World War II has helped us to weather crises ranging from speculative flare-ups in the London gold market to a major attack on the pound sterling.

Wherever we look we see complex problems without apparent solutions on which all can agree. Some individuals propose their own simple solutions but when one compares their several solutions they frequently cancel out. We have all been forced to reconsider our objectives and the appropriate means of achieving them. Today I should like first to trace how new problems have emerged and forced us to recognize the inadequacy of our inherited solutions, and second to comment on the current efforts to achieve our multiple objectives.

I begin with my own introduction to the study of economics some forty years ago. We developed an internally consistent theory -- or as it is now phrased, we constructed a model -- in which reasonably full utilization of resources, a reasonably stable level of prices and reasonable balance in our

international accounts were consistent goals whose achievement would produce growth.

In broadest outlines, the theory ran something like this. Let us suppose that a country is experiencing a recession. It will have rising unemployment and declining prices. The lowered prices will make it a favorable place from which to buy and a poor market in which to sell. The developing favorable balance of trade would be financed by gold imports and capital exports. Pursuit of all objectives would call for a cheaper and easier monetary policy. As such policies stimulated aggregate demand, employment would rise, in due course prices would rise also, and the international trade position would become unfavorable. At this point all signs would point to a tightening of monetary policy.

I need not tell you that American economic development since the end of the war has not fit this model. During the war and early postwar period it was assumed that unemployment would be our major economic problem. You may recall the gloomy predictions of economic chaos. The specter of the 1930's reappeared. The vast increase in productive capacity created during the war brought visions of large chronic unemployment. One result of our concern with unemployment was passage of the Employment Act of 1946, which directed all agencies of Government to coordinate their efforts toward the end of fostering maximum employment.

Yet even then anxious eyes were scanning the horizon for other problems which might disrupt the nation's economic equilibrium, problems which would increase the likelihood of conflict in the attainment of multiple objectives.

These problems were quick to emerge. Fears of massive unemployment soon gave way to a growing concern with inflation. The high volume of liquid

assets accumulated during the war years, combined with generally rising current income and removal of direct controls, helped to stimulate a massive demand for goods. The result: rapidly rising prices.

Between 1945 and 1949 consumer prices jumped 25 per cent and wholesale prices climbed over 30 per cent. The President, in his economic reports to Congress, expressed grave concern over the problem. Though restrained in its actions by the policy of supporting Government security prices, the Federal Reserve stressed the importance of price stability.

In short, the problem of maintaining price stability had taken its place beside that of promoting maximum employment. In the late 1940's a dip in Gross National Product and in personal income was accompanied not only by rising unemployment but by rising prices -- not falling prices, as our theory implied. The multiple objectives of national economic policy raised the possibility of conflict and led to revival of the so-called cost-push theory of inflation.

Nor did the problem of multiple goals stop here. As the postwar period progressed, political developments added new dimensions to our economic problems.

At the end of World War II, this nation heaved a collective sigh of relief. The war was won. The nation seemed confident that peace had been achieved in our time. American troops came home. Military forces were reduced. Indeed, so rapid was the return to civilian life that some called it a military disintegration rather than a demobilization.

Soon, however, the bright hopes of peace and world cooperation were dashed upon the stark reality of Soviet expansionism. The awesome power of Soviet military might -- 200 divisions in Europe plus the forces of its satellites -- faced the largely disarmed and economically feeble Western European democracies.

That was the world scene. Something had to be done to redress the strikingly one-sided balance of power. The United States was the only nation which could do the job.

In the process of coming to grips with the Soviet threat -- and that, of course, is a long story in itself -- new national economic goals emerged. Increasing emphasis was placed upon growth. We wanted not only maximum employment but also a rising real output per capita, so that we could meet commitments abroad and, at the same time, raise living standards at home.

But our increasing foreign commitments had even further effects on our set of economic goals. Building and manning military bases and installations and aid for reconstruction and development created a large outflow of dollars. As long as foreigners used dollars to buy our products and to build depleted monetary reserves to desired levels, all went well. Indeed there was widespread concern that the world was faced with a "dollar gap" that could not be filled.

But insoluble problems are transient. By the end of the fifties the dollar gap became a dollar glut. As the countries devastated by war were rebuilt, they became relatively less dependent upon the United States for imports -- indeed, became competitors in foreign and domestic markets. With business booming abroad, our citizens and corporations invested in productive enterprises and high-yielding loans and securities in foreign lands.

Once again the American people had a lot of new thinking to do. By 1958, when great strides were made toward currency convertibility abroad, we found ourselves paying to foreigners far more than we received. Reduction of this deficit was added to our list of national economic goals. Once more the probability increased that multiple goals might come into conflict and that relative priorities would have to be reconsidered and a proper mix of national economic policies would have to be developed to bring optimum results.

This is precisely where we find ourselves today. Let us, therefore, focus our attention on the more recent behavior of our policy goals. What has been the recent trend of prices, employment, the balance of payments and economic growth? What guides do these trends offer to the Federal Reserve System?

As for prices, we are experiencing the most sustained period of stability in wholesale commodity prices in our entire economic history. This would suggest that policy has been about right and should not be changed.

On the other hand, unemployment has remained a serious problem, holding at near five per cent of our labor force, well above the four per cent interim target level of national economic policy. Unemployment, as a guide to monetary action, would suggest a need for greater monetary ease.

Next, our balance of payments showed a sizable deficit in 1964, and as a guide to policy, would call for greater restraint.

Finally, real output per capita rose substantially more in 1964 than in all but one of the past five years. Unfortunately, our enthusiasm for this result is modified by the fact that we still have large unused material as well as human resources. As a guide to policy, therefore, growth does not give a clear indication.

Totaling up the scoreboard, then, we have one vote for no change: prices; one vote for greater ease: unemployment; one vote for more restraint: the balance of payments; and one indecisive vote: growth. Obviously the objectives of policy give us conflicting guides to the implementation of policy.

We need more than mere statistics. We need to use judgment. We, as central bankers, like you, as commercial bankers, must weigh risk against return.

According to the theory of my youth our only option would be to weigh the benefits that tighter money might confer on the balance of payments against

the risks that it would weaken the underpinnings of domestic growth and employment. Faced with this dilemma, it is surely understandable that one would take another look at his theory.

Although the balance of payments and unemployment are related, there is merit in analyzing them separately with the hope of devising means of dealing constructively with each without imperiling the other. This selective approach is the direction in which national economic policy has been moving.

Let us look first at employment. It is increasingly clear that in a rapidly automating society, full employment without inflation calls for both a high level of aggregate demand and for qualified workers in the right place.

On the side of stimulating consumer demand we have had the income tax cuts of 1964 and 1965 and have excise tax cuts in prospect. The Federal Reserve, on its part, has facilitated the flow of a large and increasing volume of funds at moderate rates through the capital and mortgage markets. Total funds flowing through the capital markets increased from \$58 billion in 1962 to \$62 billion in 1963 and \$71 billion last year.

In dealing with structural unemployment, it is recognized the skills and education necessary to gain employment often do not coincide with the skill and educational level of the job seeker. Examples of actions designed to deal with that problem include the Manpower Development and Training Act of 1962; the Economic Opportunity Act of 1964, better known as the Anti-Poverty Bill, which established such programs as the Job Corps to provide work experience and training for youths in conservation camps and in urban and rural training centers with emphasis on remedial education and manual skills, Neighborhood Youth Corps for training and part-time work aimed at 16 to 21 year olds who are school dropouts or potential dropouts; the Elementary-Secondary Education Bill with a first year expenditure estimated at \$1 billion to be allocated to school districts which

have large numbers of low-income families; the Appalachia Assistance Bill, which authorizes expenditures of more than \$1 billion for the development of that depressed region.

Let us now look at the balance of payments. Here, too, we have combined the general with the selective approach. The chief contribution that monetary policy has made has been in the short-term area. Treasury bill rates, which were below  $2\frac{1}{2}$  per cent in 1961 are now near 4 per cent. The banking system, which held net free reserves of about \$100 million a year ago, has recently been operating under the constraint of more than \$100 million of net borrowed reserves. At the height of the sterling crisis last year the discount rate was increased from  $3\frac{1}{2}$  per cent to 4 per cent, as high a level as any in the past 35 years. The Treasury has contributed to these results by issuing additional bills. Taken together, these actions have enabled U. S. Treasury bills to remain competitive on a covered basis with short-term Government issues in London and Canada.

In addition, interest rates on official foreign and international time deposits were made exempt from Regulation Q and maximum rates on other time deposits were raised successively to enable American banks to compete for foreign private deposits.

The Federal Reserve has entered into arrangements with foreign central banks whereby reciprocal lines of credit are made available to provide financing for temporary balance of payments needs. At present such swaps with eleven central banks and the Bank for International Settlements exceed \$ $2\frac{1}{2}$  billion. Their effectiveness in preventing crises has been illustrated on numerous occasions, such as the time of the assassination of President Kennedy. Frequently natural forces have operated to enable such swap drawings to be repaid before maturity. Incidentally, a complete report



of such operations is published regularly in the FEDERAL RESERVE BULLETIN.

The Government has taken other measures to absorb dollars that might otherwise have been converted into gold. It has sold special issues of securities -- the so-called Roosa bonds -- to countries that have accumulated excess dollars. It has negotiated agreements with individual countries to use accumulated dollars to prepay debts owed to the United States. It has made agreements with West Germany to offset our defense expenditures there with German equipment purchases here. It has intensified its effort to trim military outlays abroad and to see that all possible foreign-aid dollars are spent in this country.

With restoration of convertibility in the late 1950's, vast new opportunities for private American investment became available, and such investment added to our balance of payments problem. We continued to export each year more than we imported; but the balance was not sufficient to offset our continuing governmental expenditures for defense and development and these rising investments. Each year we became wealthier on international account, but as we increased our solvency, we reduced our liquidity.

Measures have been taken to increase the net yield of domestic investment relative to that of foreign investment. Depreciation allowances were increased. An investment tax credit of 7 per cent is allowed for new plant and equipment. The corporate income tax rate has been reduced both last year and this.

An interest equalization tax has been imposed on purchases by United States citizens of stock and debt issues of selected foreign nations to make investment in those countries less attractive. Recently, the tax has been extended to bank loans of one year or more maturity to the same countries. A program is also being prepared to encourage foreign investment in the United States.

In February, the President called on banking and business to exercise restraint in lending and investing abroad. He asked the Federal Reserve System to guide the program as it affects financial institutions and the Secretary of Commerce to supervise others.

Guidelines have been developed to permit a maximum of flexibility and yet achieve the national purpose. For banks, over-all targets have been established at 5 per cent above the level of credit extended at the end of last year. Within this target priorities are established for export credits and underdeveloped countries.

Although it is too early to measure the results of the program, preliminary indications are highly favorable. Euro-dollar rates have risen and there is evidence that dollars are not as readily available abroad. Occasional complaints are heard from some of those who were most emphatic that we "do something" about our balance of payments, that we now be careful not to go "too far."

The use of selective as well as general measures arises from the complex nature of our problems. They are designed to redress our balance of payments without depressing domestic prosperity and thus aggravating our unemployment.

Looking to the longer run, we have some powerful economic forces working for us. We have maintained stability in our wholesale price level. In contrast, industrial prices in the European Common Market have increased more than 10 per cent on average in the past four years. We have achieved this record through research and development which has increased our efficiency and resulted in rising standards of living. It is imperative that we continue this excellent record; and it can be done.

Second, our investment in the rest of the world exceeds foreign investment here by some \$40 billion. The net return each year is a powerful plus in our balance of payments. As Western Europe catches up and develops its own capital markets, the relative attractiveness of their markets for our funds may well diminish, particularly if we maintain or increase our rate of growth at home.

Third, continued negotiations with our allies to share more equitably the military and economic aid burdens and to reduce tariff barriers and other trade restrictions could produce significant results for our balance of payments.

We do, indeed, have powerful forces working for us in the long run. But we are confronted with temporary difficulties. It is important, therefore, that the voluntary restraint program be successful. Once we demonstrate that we have brought our balance of payments under control, we can hope to make progress in devising a more effective international monetary and financial system. Such a system should indeed put pressure on a member that is running a deficit because of domestic inflation. It should not require a member that has stable prices and large unused resources to put pressure on its own economy.

An economic sneeze in the United States may no longer spread pneumonia abroad, but it remains true that the greatest bulwark of the western world is a prosperous and growing United States.

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